Investors' Payday 101

How UC regents spin public money into private profit

By Peter Byrne

Photograph by Monica Jensen

PRIVATE EQUITY: Richard Blum, husband of Sen. Dianne Feinstein, is at the heart of the UC Regents' conflicts of interest.

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Last fall, amid an unprecedented state budget crisis, the University of California Board of Regents took extraordinary measures to cut costs and generate revenue. Lecturers were furloughed, classes eliminated. The regents—governing body for the vast public university system—also reduced admissions for in-state students while increasing the cost for out-of-state students. And to the consternation of tens of thousands of students, the regents raised undergraduate tuition by a whopping 32 percent, with more hikes to come.

It now costs about $30,000 per year to attend the UC system as an undergraduate, including tuition and expenses. Even with student aid, it's a sum beyond the means of many students and their families.

But while education is taking a beating, this investigation reveals that some members of the Board of Regents have benefited from the placement of hundreds of millions of university dollars into investments, private deals and publicly held enterprises with significant ties to their own personal business activities. Conflicts of interest have arisen because some members of the regents' investment committee, individuals who are also Wall Street heavy hitters, modified long-standing UC investment policies. Specifically, they steered away from investing in more traditional instruments, such as blue-chip stocks and bonds, toward largely unregulated and risky "alternative" investments, such as private equity and private real estate deals.

The activities of two regents in particular—Richard C. Blum, husband to Sen. Dianne Feinstein, and fellow financier Paul Wachter—are spotlighted. Blum, for example, benefited from UC investments of $748 million in public companies and private deals in which he held significant financial interests. Governor and regent Arnold Schwarzenegger and his longtime business partner Wachter benefited from $486 million in UC investments into firms and deals in which they held significant interests. Regent Sherry Lansing benefited from a UC investment of $397 million in a firm on whose board she sits. The UC has also invested $53 million into two for-profit "diploma mills" largely owned by Blum Capital Partners; and Sen. Feinstein initiated federal legislation that benefited these two educational corporations. (Further details on these investments can be found at Spot.us.)

State Sen. Leland Yee, D-San Francisco, was asked to review the findings of this investigation prior to publication. "These are amazing conflicts of interest," he concluded. "They happened after the UC Regents' investment committee drastically changed policy away from investing in fixed-income securities and into risky private equity buyout funds, thus enriching several regents with ties to those funds."Other ethics experts agreed. Robert Weissman, president of Public Citizen, the liberal good-government advocacy group based in Washington, D.C., was also apprised of the findings of this investigation prior to publication. "A third-grader can see that what the regents on the investment committee are doing is unethical," he said. "It goes far beyond the 'appearance' of a conflict of interest. These are core conflicts of interest."

The regents are—and always have been—a fabulously politicized body.

On June 23, 1974, the *Los Angeles Times* published an investigation titled "UC Regents: An Elite Club That Runs a Vast University." The story revealed that many of the regents were millionaires with little or no background in education policy. Most had plenty of experience leveraging political connections for pecuniary gain. This wealthy group of socialites, lawyers, oil men and industrialists was out of touch with students and the common people, the Times observed: "They drive fine cars and own boats and airplanes. They belong to the best clubs and play tennis on their own private courts." And in their dealings with each other, "the camaraderie and gentility of a private club are maintained. . . . Most regents consider it bad form to discuss their finances."

In the past half-century, the financial pedigrees of many regents have created particular challenges for avoiding conflicts of interest. In 1965, free-speech activist Marvin Garson responded to a call by the California Federation of Teachers to "investigate the composition and operation of the Board of Regents." He produced a well-documented study noting that, "taken as a group, the Regents are representatives of only one thing—corporate wealth."

In 1970, the California state auditor found that regent Edwin W. Pauley, owner of Pauley Petroleum, had personally profited when university officials steered $10.7 million into one of his company's business deals. Following this and other revelations, the regents passed a conflict-of-interest policy prohibiting university officials from "making personal gain out of university transactions." The regents were also increasingly bound by state laws enacted to monitor the ethical behavior of public officials.

In 1972, voters passed a statewide proposition requiring open meetings of public bodies, which includes the Board of Regents. And two years later came the California Political Reform Act of 1974, which prohibits public officials from even the appearance of using their position to influence governmental decisions that might be personally beneficial. To increase transparency and accountability, each regent must now file an annual economic disclosure report listing his or her assets in California.

Notwithstanding these safeguards, conflicts of interest continued to arise:

• In 1978, the state auditor found that UC was improperly investing in a corporation that included a regent on its board of directors.

• In the early 1990s, the state auditor reported that some regents were improperly availing themselves of lavish travel and entertainment allowances. This audit unleashed a storm of public outrage, since the regents had simultaneously raised tuition.

• In the mid-2000s, a series of media exposés were published concerning a variety of problems at UC, including excessive salaries and benefits for UC administrators; the regents' mismanagement of the nation's nuclear laboratories; and the hiring of an investment firm (Wilshire Associates) with business connections to then-regent Gerald Parsky, a financier.

Today, UC's current operating budget is $20 billion. The various endowment and retirement funds totaled $63 billion at the end of 2009. With such an enormous amount of public funds in play, the regents are bound to meticulously adhere to state laws and university policies that prohibit self-dealing. It is incumbent upon those individuals who are charged with overseeing the UC pension and endowment funds to avoid influencing or voting on investment decisions that potentially, actually or even appear to affect their personal business affairs.

Many members of the current crop of regents have failed to consistently hold themselves to these ethical standards—especially when it comes to private equity investments.

Private equity investing is attractive to sophisticated investors and large institutions because it has the potential for large returns. But unlike deals that take place on public stock exchanges—where sales and purchases are public information and regulated by the U.S. Securities and Exchange Commission—the realm of private equity is opaque, largely unregulated and extremely difficult to exit should a deal go bad.

It was 2003 when regents Blum, Wachter and Parsky, who left the board in 2008, consolidated control of UC's investment strategy. Bypassing the university treasurer's in-house investment specialists, the regents' investment committee hired private managers to handle many of these new kinds of transactions. This action increased management costs and limited transparency (since these external managers are not subject to public-record laws).

Soon, the amount of money placed in private equity had more than tripled, and by March 2009, the university's books carried a balance of $6.7 billion in 212 private equity partnerships, which consist primarily of leveraged buyout funds, more than 10 percent of the investment fund total of $63 billion.

These have not proven to be prudent investments.

UC's private equity returns, as of spring 2009, were running at a negative 20 percent since the inception of the investment, according to the treasurer's most recent annual report. According to operating reports made to the investment committee by the current UC treasurer, Marie Berggren, much of the loss to the portfolio was tied to the souring of leveraged buyouts during the recession.

In a leveraged buyout, private equity firms act as a "general partner" by arranging private investment opportunities to purchase companies or real estate. The general partner finds "limited partners"—typically institutions, pension funds or wealthy individuals—to invest in that fund. (The limited partners have little or no say in how the fund operates, since it is being managed by the general partner.) The capital provided by the limited partners is used as a down payment for the purchase, and a large bank loan covers the remainder of the sale price.

Although leveraged buyouts can be lucrative for both the limited and general partners, the buyout can also take on a predatory quality. In this scenario, the limited partners have the most to lose.

Here's how the darker version of these deals goes down: Once a company has been acquired, the investors can offload the responsibility for paying back the large bank loan onto the company itself. At the same time, the new owners can strip the acquired company of cash and other valuable assets to pay dividends to the general partners. Looted companies often collapse from a lack of operating capital brought about by trying to pay off the combination of the unsustainable debt burden and the dividend payouts.

Collapse can cause the limited partners to lose their entire investment. The private equity firm's general partners may survive because they can charge their investors management fees regardless of a deal's outcome. While less predatory leveraged-buyout acquisitions can certainly benefit both the acquired company and all of its investors, the companies involved in the UC deals discussed in this story, for the most part, do not fall into the beneficial category.

In 2009, Berggren reported that the average annual "internal rate of return" for the retirement plan's private equity portfolio since 1979 was a mere 1.8 percent. But fixed-income investments had generated an average annual rate of return of 6 percent over a similar period. The only sector of the portfolio that fared worse than private equity was private real estate.

After the financiers took control of the investment committee, the university's allocation to private real estate deals increased from nearly zero to $4.5 billion in less than a decade. By mid-2009, the private real estate portfolio had lost an astonishing 40 percent of its value.

Nonetheless, this notable shift in strategy toward alternative investments—leveraged buyouts, in particular—has had clear benefits for individual regents. And good-government experts question the ethics of these investments. "The investment committee's act of increasing UC's allocation to private equity was an extraordinary conflict of interest," said Public Citizen's Weissman. "Some of these regents obviously had vested interests."

The private equity losses should not have surprised the regents. In 2008, Berggren stated in her annual report to the investment committee that private equity and private real estate investments were "overweighted" relative to other financial vehicles during the boom years. She also noted that the regents' preference for private investment was disproportionately impacting UC during the economic recession.

Amazingly, in the face of the disastrous performance of private equity and private real estate, Wachter and Blum have continued to advise Berggren to increase UC's investments in these two ailing sectors.

At the February 2009 meeting of the regents' investment committee, Wachter, then the committee chair, observed that although private equity and real estate investments were already "overweighted" in the portfolio, they should be "even more overweighted."

At an investment committee meeting three months later, Blum, who was then the chairman of the board of regents, urged his colleagues to continue on the same questionable course. According to the meeting minutes, "Chairman Blum expressed concern that the university might become too risk-adverse."

At the same meeting, Wachter suggested that UC buy bundles of distressed real estate and mortgage debt to profit off of the collapse of the housing market. (Though a matter of continued debate, experts say such investments are a risky undertaking, since another wave of home foreclosures is expected.) Recently, Wachter has championed increasing the volume of UC's investments in risky timber and oil ventures.

But the entire investment committee is not in lockstep with Wachter and Blum's predilection for alternative investments. Regent George Marcus, a real estate executive who sits on the committee, has consistently opposed them. In a March 2010 meeting, he described this strategy of overemphasizing private equity as the equivalent to "gambling in Las Vegas."

Blum would not respond to repeated written requests for comment. In an emailed statement, Berggren's spokeswoman Lynn Tierney said, "It's misguided to assume that there's a conflict of interest simply because there's an overlap between personal investments by University of California Regents and investments made by the UC Treasurer's Office. The real issue is whether Regents communicate with the Treasurer's office about specific investments."

Blum Capital, based in San Francisco, handles a $2 billion portfolio. Regent Blum is the chairman of the investment firm's board. He is also a principal executive and an owner of Fort Worth's $45 billion private equity firm, TPG Capital, which has a history of partnering with a New York–based private equity firm called Apollo Management.Wachter, meanwhile, has disclosed multimillion-dollar holdings in a range of Apollo Management funds.

During Blum and Wachter's seven-year tenure together on the regents' investment committee, UC has invested nearly $750 million in private equity deals involving Apollo Management, Blum Capital Partners and TPG Capital. Several of these deals received contributions from the California Public Employees' Retirement System, the country's largest public pension fund, for which Blum Capital Partners is a paid investment adviser.

What follows are summaries of just a few cases in which UC had invested and where Blum had concurrent business interests; one of these deals (Harrah's Entertainment) involved Wachter.

These facts were ascertained from reviewing thousands of pages of U.S. Securities and Exchange Commission filings, commercial databases, UC public records and press accounts.

1. Harrah's Entertainment

Las Vegas, Nevada

The company: Harrah's Entertainment operates 52 casinos in seven countries.The deal: In 2008, investment firms TPG Capital, Apollo Management and the Blackstone Group partnered in a leveraged buyout of Harrah's for $30.7 billion.

The Blum connection: In 2008, Blum disclosed investments worth "over $1 million" in various TPG funds (including funds named TPG IV and TPG V).

He was also a TPG Capital owner and executive.

The Wachter connection: Since becoming a regent, Wachter has disclosed investments worth "up to $1 million" in two Apollo investment funds (Apollo VI and VII) that provided

capital to the Harrah's deal.UC's investment: At the time of the Harrah's transaction, UC had $75 million invested in the same two Apollo Management funds in which Wachter was invested and which were themselves invested in the Harrah's deal. During that period, UC also held $4.1 million in two TPG Capital funds, including one that helped finance the Harrah's deal (TPG V). The investments in the TPG funds were made by several UC campus endowment foundations overseen by the regents while Blum—a TPG Capital executive who was himself invested in the Harrah's deal (via TPG V)—served on the regents' investment committee. UC also had $120 million invested with a private equity fund run by the Blackstone Group (Blackstone Capital Partners V), which participated heavily in the Harrah's buyout.

In total, UC's general endowment and retirement funds committed $200 million to four private equity funds that financed the Harrah's buyout, a deal in which Blum and Wachter each had significant financial interests.

The fallout: Since the buyout, Harrah's has hemorrhaged capital due to the overall decline of the gambling industry amid the global recession. Its ability to generate enough cash to pay back limited partner investors such as UC has been hampered by the $12.4 billion acquisition debt that Apollo Management, TPG Capital and the Blackstone Group placed on the books of the casino empire after acquiring it. UC's investment in the private equity funds that participated in the Harrah's deal had lost up to 40 percent of their value as of March 2009.

2. Washington Mutual

Seattle, Washington

First American Corporation (now CoreLogic)

Santa Ana, California

The companies: Before its acquisition by New York's JPMorgan Chase, Washington Mutual was one of the country's largest banks. In the fall of 2007, it stunned investors by declaring a loss of several billion dollars in the sub-prime housing market. Simultaneously, the New York attorney general sued a title company, First American Corporation, for conspiring with WaMu to inflate real estate appraisals. The price of WaMu and First American stock fell through the floor.

The deal: In June 2008, in a major miscalculation of risk factors, TPG Capital bought a $7 billion stake in WaMu, becoming its largest shareholder.

The Blum connection: Blum participated in the WaMu investment through an interlocking series of TPG Capital funds (including TPG V and a related fund named Olympic Investment Partners). Blum Capital Partners also invested heavily in First American shares when the price plummeted following the allegations of appraisal collusion.

UC's investment: In 2008, the UC Berkeley campus endowment fund invested $4.1 million in two TPG Capital funds that financed the WaMu deal (TPG V and TPG VI). UC retirement-fund managers made a bad bet by increasing their stake in WaMu bonds sevenfold, from $31 million in 2006 to $215 million by the end of 2007. Through its external managers, UC also purchased First American stock when its share price fell, putting $7 million into the failing company by the end of 2009.

The fallout: The Federal Deposit Insurance Corporation seized WaMu in September 2008, selling its assets on the cheap to JPMorgan Chase. Stockholders were wiped out. TPG Capital is reported to have suffered a loss of $1.3 billion, which would likely negatively affect the fund that UC had invested in (TPG V), although this information is not public. By the end of 2008, the value of UC's investment in WaMu bonds had declined by $48 million. First American continues to struggle financially and in the courts.

3. Univision Communications

New York, New York

The company: Univision Communications is the dominant Spanish-language media company in the United States, operating 62 television stations and 69 radio stations.The deal: In March 2007, a consortium of five private equity investment companies led by a former UC regent named Haim Saban acquired Univision Communications in a $13.7 billion leveraged buyout. The private equity investors were Saban Capital Group, TPG Capital, Madison Dearborn Partners, Providence Equity Partners and Thomas H. Lee Partners.

The Blum connection: Blum participated in the Univision deal through his investments in two TPG Capital funds (TPG IV and TPG V). His spouse, Sen. Dianne Feinstein, disclosed Univision as an asset in 2007. Blum also maintained a financial interest in the deal by virtue of being a principal executive and owner of TPG Capital.

UC's investment: A member of the UC investment committee, Saban resigned as a regent in 2004. Saban then put together the Univision deal. During the acquisition, UC campus endowment funds had invested $4.1 million in two relevant TPG Capital funds (TPG IV and TPG V). Additionally, UC had invested $150 million in the two Madison Dearborn funds that financed the Univision buyout (Madison Dearborn IV and Madison Dearborn V).

The fallout: Following the buyout, Univision's new owners—including TPG Capital and Apollo Management—placed the $10 billion debt from the buyout on the company's balance sheet, creating a financial burden. The value of UC's investment in one Madison Dearborn

fund decreased by 17 percent as of the spring of 2009, while the other showed a gain of 18 percent. Apollo Management and TPG Capital collectively charged its investors, including UC, a $200 million transaction fee for managing the deal.

4. Glenborough Realty Trust

San Mateo, California

The deal: Glenborough Realty Trust was sold to Morgan Stanley Real Estate in a $1.8 billion leveraged buyout that took the company private in November 2006.

UC's investment: UC invested $42 million in the Morgan Stanley private equity investment fund that bought Glenborough.

The Blum connection: In addition to his executive position with the global real estate giant, CB Richard Ellis, Blum's business interests include the purchase and sale of real estate companies for his personal portfolio. At the time the Glenborough deal was approved by UC, Blum owned Glenborough stock worth about $2.5 million, and he sat on the company's board of directors. The SEC disclosure statements filed by the real estate company prior to the sale show that as a member of its board of directors, Blum would see direct financial benefit if UC invested in the Morgan Stanley fund that financed the buyout.

Details of the deal: Glenborough owned scores of high-end office buildings in a half-dozen major cities, including San Francisco. Private equity suitors regularly came calling on the Glenborough board of directors, hoping to buy the profitable company. Morgan Stanley won Glenborough's hand with a $1.9 billion offer via one of its private equity investment funds (MSREF V).Public records show that before the sale, UC held $8 million in this Morgan Stanley fund. After the sale of Glenborough was announced, UC increased this amount by $34 million, for a total investment of $42 million.The Morgan Stanley fund put up a cash payment of $325 million to realize the Glenborough deal (UC's contribution, via the Morgan Stanley investment fund, was equivalent to 13 percent of the cash that was made as a down payment). The majority of the remaining $1.8 billion purchase price was leveraged by a loan from Deutsche Bank Securities. The original members of the Glenborough board of directors, including Blum, sold their stock at a premium price.

The fallout: Glenborough was saddled with a tremendous debt load from the acquisition, and it struggled mightily to meet the loan obligation. The deal turned out to be a bad investment for UC. By the end of 2009, due to the collapse of the real estate market and the company's debt burden, the value of UC's investment in the Morgan Stanley fund had plummeted to $3.5 million, recording an apparent loss of $38.5 million.

Peter Byrne is an investigative reporter and science writer whose column 'The Byrne Report' appeared in these pages from 2004 to 2007.

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